No. 92-1384

In the Supreme Court of the United States

OCTOBER TERM, 1993

BARCLAYS BANK PLC, PETITIONER

v.

FRANCHISE TAX BOARD OF CALIFORNIA

ON PETITION FOR A WRIT OF CERTIORARI TO THE COURT OF APPEAL OF CALIFORNIA, THIRD APPELLATE DISTRICT

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

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QUESTION ADDRESSED BY THE UNITED STATES

Whether, as applied (i) to a domestic corporation that has a foreign parent or (ii) to a foreign corporation that has a foreign parent or foreign subsidiaries, California's use of the worldwide formula apportionment method to allocate income for tax purposes violates the Commerce Clause of the Constitution.

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This brief is submitted in response to the Court's order inviting the Solicitor General to express the views of the United States.

STATEMENT

1. Different methods have been used to identify and allocate among taxing jurisdictions the income received by multinational corporations. The method employed by the United States is known as the "separate accounting" or "arm's length" method. This method generally treats each corporation as a distinct tax unit, doing business with every other corporation (including its parent, subsidiaries or affiliates) on an arm's length basis. The separate accounting method of taxation is employed in the Internal

Revenue Code and in the many bilateral tax treaties to which the United States is a party (Pet. App. H43).[1] The separate accounting method is also employed by most other nations for both domestic and international purposes.[2]

Another method of allocating corporate income among taxing jurisdictions is the "worldwide combined reporting" method that was, with respect to the tax years involved in this case, used by California and a few other States.[3] Under

[1] There are, of course, distinctions and refinements employed in the Internal Revenue Code to forestall potential abuses of the separate accounting method. See, *e.g.*, 26 U.S.C. 482, 551-558, 951-964.

[2] The international practice is described in the letter to Governor Deukmejian of California, dated January 30, 1986, from Secretary of State George P. Shultz (Pet. App. H43-H45). The arm's length method is the primary method for allocating income internationally. Other than in a few States of the United States, the worldwide combined reporting method has not been used at the national or subnational level by the United States or any of its major trading partners.

[3] Under legislation enacted in 1986 (effective in 1988), California provided corporations with a "water's edge" election to avoid application of worldwide formulary apportionment to the income of their foreign affiliates and parents. See Cal. Rev. & Tax. Code § 25110 (West 1992); Pet. App. B4 n.2. In general, the "water's edge" method permits a taxpayer to report its earnings separately from the earnings of its foreign parents or affiliates and is thus consistent with arm's-length principles of taxation. See Pet. App. B4 n.2 ("The 'water's-edge' method is essentially an [arm's length, separate accounting] method"). This case does not directly consider or address the "water's edge" method of taxation because it concerns tax years that preceded California's adoption of that method.

On September 10, 1993, California enacted legislation to remove the fee the State previously had imposed on corporations that elected "water's edge" treatment under the 1986 legislation and also to remove the preexisting regulatory authority under which respondent could disregard a "water's edge" election and require a corporation to report its income on a worldwide apportionment basis. See page 9, *infra*. Under this new legislation, both domestic and foreign corporations subject to tax in California may now freely elect taxation under the "water's edge" method. See *ibid.* The State has abandoned any mandatory requirement or economic compulsion designed to impose worldwide formulary apportionment on foreign corporate groups – and has thus abandoned the tax system that petitioners seek to challenge in this case.

the California tax provisions in effect when this suit was commenced, the State generally ignored the separate corporate existence of parents, subsidiaries and affiliates engaged in a unitary business, pooled their world-wide income together, and allocated a portion of that combined income to California based upon a multi-factor apportionment formula.[4] See *Container Corp.* v. *Franchise Tax Board,* 463 U.S. 159, 162-163 (1983). Prior to the adoption of extensive revisions in the California tax scheme in 1986 and 1993 (see note 3, *supra*), California applied its worldwide combined reporting method not only to domestic parent corporations with foreign subsidiaries (see *ibid.*) but also to domestic subsidiaries (conducting business in California) with foreign parents and to foreign parents (conducting business in California) with foreign subsidiaries.

The United States has long taken the position that California's application of the worldwide combined reporting method of taxation to corporations doing business in Cali-

[4] Under the three-factor apportionment formula used by California, the in-state corporation's income is calculated as a percentage of the total income of the group of related corporations. After the unitary business group is identified, the in-state corporation's sales, property, and payroll are expressed as a fraction of the total sales, property, and payroll of the unitary group. These three fractions are arithmetically averaged. This average is then multiplied against worldwide group income to yield the taxable income of the in-state corporation (Pet. App. C5).

fornia that have foreign parents or foreign affiliates is inconsistent with the "separate accounting" or "arm's length" method applied under federal law and under established international practice. In letters addressed in 1986 to the governors of the six States that then employed the worldwide combined reporting method of taxation (Alaska, California, Idaho, Montana, New Hampshire and North Dakota), the Secretary of State expressed the concern of the United States that state use of worldwide combined reporting was "at odds with the position of the United States and has become a source of conflict with foreign states" (Pet. App. H44). Major trading nations advised the United States during this period that the worldwide combined reporting method of taxation applied by these States constituted "a serious obstacle to the further development of our trade and investment relationships" (*ibid.*). The United Kingdom went beyond the formal expression of diplomatic protest and, in 1985, enacted legislation to provide retaliatory tax treatment for United States corporations that operate in the States that apply the worldwide combined reporting method.[5]

2. The taxpayers involved in this case are Barclays Bank International Limited (BBI) and Barclays Bank of California (Barcal). During 1977, Barcal (a United States corporation conducting banking activities in California) was a wholly owned subsidiary of BBI (a United Kingdom corporation conducting an international banking business).[6] Both BBI and Barcal did business in California and were therefore subject to tax in that State (Pet. 4-5; Pet. App. A36-A38).

In computing its California income tax for 1977, Barcal used the separate accounting method and reported only the income it earned from California sources. In computing its California income tax for 1977, BBI reported not only the income it earned from California sources but also included (i) the income BBI earned from operating bank agencies and branches in the United Kingdom and approximately 33 nations or territories outside of the United Kingdom and (ii) the income earned by 70 subsidiaries (including Barcal) of BBI operating in 34 nations or territories outside of the United Kingdom. BBI did not, however, include the income of BBI's parent (see note 6, *supra*) or of the parent's subsidiaries. Thus, neither Barcal nor BBI submitted its California tax return under the worldwide combined reporting method required by California (Pet. 5-6; Pet. App. A36-A40).

The California Franchise Tax Board determined that Barcal and BBI were members of a worldwide unitary business conducted by all members of the Barclays Group. That Group included (i) Barcal, a wholly owned subsidiary of BBI doing business only in California; (ii) BBI, a United Kingdom corporation doing general retail and commercial banking in the United Kingdom and 34 other nations or territories outside the United Kingdom, including California; (iii) the subsidiaries of BBI in which BBI had more than a 50% interest; (iv) Barclays Bank Limited, a United Kingdom corporation which conducted

[5] The United Kingdom legislation would deny tax credits on the taxes owed by such corporations for dividends they receive from their United Kingdom subsidiaries. See Finance Act 1985, Pt. II, ch. I, § 54, and Sch. 13, ¶ 5 (Eng.), reenacted without substantial change in Income and Corporation Taxes Act 1988, Pt. XVIII, ch. III, § 812 and Sch. 30, ¶¶ 20 and 21 (Eng.). See also Parliamentary Debates (Hansard) 1014-1018 (10 July 1985); Secretary of State Shultz's letter to Governor Deukmejian (Pet. App. H45).

[6] BBI was a wholly owned subsidiary of Barclays Bank Limited, a United Kingdom corporation. In 1982, Barclays Bank Limited changed its name to Barclays Bank PLC, which is named as the petitioner in this case (Pet. 2-3).

no business in California and which owned 100% of the stock of BBI; and (v) the subsidiaries of Barclays Bank Limited in which that corporation held more than a 50% interest. The California Franchise Tax Board calculated the tax owed by BBI and Barcal by allocating a portion of the total income of the above unitary group to these two taxpayers utilizing a three-factor apportionment formula. The State's calculation indicated a tax deficiency, which the Board then assessed (Pet. 8-9; Pet. App. A38-A41).

3. Barcal and BBI challenged the State's assessment because it was based not only on the income that they had separately earned but also on the income of their foreign parent and other related foreign subsidiaries which do no business in California or elsewhere in the United States. After paying the assessments, the taxpayers sued for a refund in California superior court (Pet. App. A38-A41).

The trial court entered judgment in favor of the taxpayers (Pet. App. A1-A34). The court concluded that California's computation of taxes by use of worldwide combined reporting improperly included income earned by foreign parents and affiliates of the taxpayers. The court held that this violated the Commerce Clause of the United States Constitution because it impeded the federal government's ability to speak with one voice in the conduct of foreign affairs (*id.* at A23-A26), impermissibly discriminated against foreign commerce (*id.* at A26-A28) and violated due process (*id.* at A29-A30).[7]

The California court of appeal affirmed (Pet. App. B1-B37). The appellate court held that California's appli-

[7] The trial court reasoned that the procedures then applicable for implementation of the State's worldwide combined reporting method violated due process because, "with customarily and currently available accounting data, literal compliance with [their] requirements is impossible for foreign multi-nationals" (Pet. App. A29).

cation of worldwide combined reporting to the income received by foreign parents and affiliates of the taxpayers violated the Commerce Clause because it frustrated the ability of the United States to speak with one voice with respect to an issue of foreign commercial relations where federal uniformity is necessary (*id.* at B35).

The California Supreme Court reversed, upholding the constitutionality of the tax under the Commerce Clause as applied in this case. The court relied extensively on the fact that, while Congress has been given many opportunities, it has not enacted legislation to prohibit the States from employing the worldwide combined reporting method to multinational corporations (Pet. App. C28-C31). Concluding from "the din" of this legislative "silence" that Congress "has decided *not* to prohibit state use" of worldwide combined reporting "in cases of this kind" (*id.* at C26), the court declined to apply the Commerce Clause to prohibit the State from enforcing a tax that Congress has not acted affirmatively to prohibit (*id.* at C24-C37).

Since the court of appeal had resolved the case without reaching petitioner's separate claims that the compliance burden imposed on foreign corporations (see note 7, *supra*) violated due process and effected a direct discrimination against foreign corporations, the California Supreme Court remanded the case to the court of appeal for further proceedings on those issues (Pet. App. C39). A petition for a writ of certiorari filed at that stage was denied by this Court. 113 S. Ct. 202 (1992).

4. On remand, the California court of appeal concluded that, while the costs of complying with the California tax were greater for foreign-based corporate groups than for domestic groups, the additional burdens were not unreasonable or arbitrary and did not violate due process (Pet. App. D14-D27). The court further held that the burdens imposed by the California compliance system did

not discriminate against foreign commerce (*id.* at D6-D14).

The California Supreme Court denied Barclays' petition for further review (Pet. App. E).[8]

DISCUSSION

For the reasons set forth in the brief filed by the United States as *amicus curiae* at an earlier stage of this case (*Am.* U.S. Br. No. 92-212), the analysis and holdings of the California Supreme Court are subject to serious question. Legislation adopted by California since the date of that submission, however, leads us to conclude that further review of the decision below is not warranted.

1. This case involves state corporate income taxes for 1977 that were assessed under a statutory scheme that no longer exists. As early as 1986, California responded to the urgings of the United States (see Pet. App. H3) and began the process of moving away from the worldwide combined reporting method for taxing the foreign incomes of foreign corporate groups. The State's adoption of the "water's edge election" in 1986—which gave corporations an opportunity to avoid an apportioned tax on the earnings of their foreign parents and affiliates—was a significant step in that direction. See note 3, *supra.* As the court of appeal noted in this case, California's " 'water's-edge' method is essentially an [arm's-length, separate-accounting] method" (Pet. App. B4 n.2) and thus generally conforms to federal and international tax practice.

[8] Petitioner seeks review of the additional rulings of the California court of appeal on remand as well as the original ruling of the California Supreme Court under the Commerce Clause. In this brief, we address only the Commerce Clause ruling entered by the California Supreme Court in its original decision in this case.

Even after the changes in California law in 1986, however, foreign governments continued to express concern that the annual fee then charged by California to corporations that elected "water's edge" treatment—as well as other, associated conditions on the election (see Pet. App. B4 n.2)—persisted as a meaningful, practical burden on the exercise of that option. Responding to these concerns, in legislation enacted on September 10, 1993, California extensively revised the State's corporate income tax system. See Cal. S.B. 671 (1993). Under this new legislation, the State (i) removed the annual fee previously imposed for "water's edge" treatment (*id.* §§ 24, 26), (ii) removed burdensome reporting requirements previously applicable to "water's edge" treatment (*id.* § 13) and (iii) removed any authority under which respondent could disregard a corporation's election and require it to file its return on a worldwide combined reporting basis (*id.* §§ 16, 23).[9]

Under the revised California legislation, the worldwide combined reporting method for assessing tax on foreign corporations is no longer compulsory in California. By invoking the provisions of the revised "water's edge" election, corporate taxpayers in California now have an unburdened right to be taxed on an "arm's length" basis and to exclude the earnings of their foreign parents or affiliates from the State's tax.[10] *Ibid.*

[9] This legislation was signed into law by the Governor of California on October 6, 1993.

[10] The "water's edge" election now offered by California does not appear to be illusory or to discriminate against foreign companies. The principal departure of the "water's edge" election from ordinary separate accounting methods is that, under the California provision, the earnings of affiliates and parents must be combined with the taxpayer's earnings when the average of the "property, payroll and sales factors" of the affiliate or parent within the United States "is 20 per-

2. Because California has abandoned compulsory worldwide combined reporting for foreign corporate groups, the issue presented and decided in the California Supreme Court in this case lacks substantial recurring importance. Corporate taxpayers in California are now generally free to elect to be taxed only on their separate earnings – and not on the earnings of their foreign parents or affiliates – under the "water's edge" method. By removing any mandatory requirement or economic compulsion for taxpayers to report their income under the worldwide combined reporting method, California's recent modifications of its tax system have brought that State's law into acceptable harmony with federal and international "arm's length" tax practice. See note 10, *supra*.

A decision by this Court on the constitutional question posed in this case is thus unnecessary to achieve adequate consistency in the Nation's regulation of foreign commerce, which California has striven to accomplish through its voluntary action. Further review by this Court is not needed to achieve, and could potentially destabilize, the accommodation of state, national and international interests that has been reached on this issue.

cent or more" (Cal. Rev. & Tax. Code § 25110(a)(3) (West 1992)). As we have noted, separate accounting tax systems often contain distinctions and refinements that depart from a strict application of the arm's-length concept. See note 1, *supra*. The record of this case, which concerns the State's tax system *before* the "water's edge" election was adopted, is obviously inadequate to address any issues that might hereafter arise in connection with enforcement of the State's new legislation.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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